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No. 84-646
No. 84-651

IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

PEAT, MARWICK, MITCHELL & CO.,
Petitioner,

v.

DAVID A. and SYLVIA S. LIPTON,
Respondents.

DOCUMATION, INC., S. RAY HALBERT, RICHARD J. TESTA, ROBERT S. AMES, JOHN H. HOLCOMB, JR., JAMES F. MORGAN and TEXTRON, INC.,
Petitioners,

v.

DAVID A. and SYLVIA S. LIPTON,
Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

CONSOLIDATED BRIEF FOR DAVID A. and SYLVIA S. LIPTON IN OPPOSITION

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Questions Presented

The question certified for interlocutory review by the district court pursuant to 28 U.S.C. §1292(b) and answered in the affirmative by the court of appeals was:

> Whether a complaint seeking damages for alleged violations of Section 10(b) of the Securities Exchange Act of 1934 [15 U.S.C. §78j(b)] and Securities and Exchange Commission Rule 10b-5 states a claim upon which relief can be granted when the complaint, asserting a "fraud on the market" theory, alleges merely that plaintiff purchased securities relying "on the integrity of the market prices" of those securities and that because of the misrepresentations and omissions alleged, "the market prices of . . . [the] securities were artificially inflated," and there is no allegation that the securities would not have been marketed at all but for the misrepresentations and omissions complained of.

Petitioners in Nos. 84-646 and 84-651 have incorrectly stated the certified question, adding to it the phrase "when plaintiffs admit they did not read or rely upon the allegedly misleading documents." This is pure invention. On this interlocutory appeal from denial of the motion to dismiss, with no discovery having been taken, there is no factual record and no such admission.

Petitioner in No. 84-646 (Peat, Marwick, Mitchell & Co.) presents a second question not presented to the lower courts and further removed from the very limited record in this case. It claims, again in the absence of any factual record whatsoever, that the auditor's only involvement was peripheral, that it acted independently and without wrongful in-

tent, and that "plaintiff was wholly unaware of the auditor's existence, much less his opinion concerning the issuer's financial statement."

Petitioners' "emendation" of the certified question and their assertion of non-existent facts point to the inappropriateness of review in the absence of a factual record beyond the pleadings.

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Petition No. 84-646 and Petition No. 84-651 both seek review of the decision on interlocutory appeal of the United States Court of Appeals for the Eleventh Circuit reported at 734 F.2d 740. David A. and Sylvia S. Lipton are named

as respondents by all petitioners and file this consolidated brief in opposition to both petitions.[1]

Statement

Plaintiffs-respondents purchased 3,000 shares of the common stock of defendant-petitioner Documation, Inc. ("Documation") on the open market (the American Stock Exchange) on May 30, 1978, at a cost of approximately $63,000.

In their Amended and Supplemental Class Action Complaint ("Complaint"), dated January 30, 1981, plaintiffs allege as follows:

In the period between May 1, 1978 and April 14, 1980, Documation reported substantial and increasing revenues and earnings. Virtually all these earnings were sham. In its public reports issued in this period there had been no disclosure of serious and growing financial problems, including a negative cash flow and possible imminent defaults on a major bank loan agreement. Instead, by means of accounting machinations a glowing financial picture was presented. These machinations included the use of an improper and grossly inadequate loss reserve for sales returns and uncollected receivables, and the failure to write down massive obsolete inventory.

On April 14, 1980, after the Securities and Exchange Commission had begun an investigation, Documation revealed that it had suffered a staggering net loss for the 1980 fiscal year, more than half of which was due to ex-

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[1] After Documation, Inc. and the individual defendants petitioned this Court for certiorari in No. 84-651, Documation, Inc. filed a Petition under Chapter 11 of The Bankruptcy Code, 11 U.S.C. §101 *et seq.* Respondents' Brief in Opposition is therefore not directed to Petitioner Documation, Inc. itself. 11 U.S.C. §362.

traordinary write-downs of inventory and accounts receivable. Further amounts were charged off to reflect properly the actual earnings of Documation in prior periods. The effect of the 1980 write-downs of over-valued inventory and accounts receivable, together with the write-down of retained earnings to reflect the adoption of a new accounting method of reporting revenue, wiped out all reported earnings for the prior three years.

Documation and its management (Petitioners in No. 84-651) pursued a common course of conduct designed to maintain an artificially high market price for Documation stock, and with wrongful intent disseminated false and misleading financial reports and releases and failed to disclose material adverse facts. As a direct result of this fraudulent conduct, plaintiffs paid prices for securities substantially greater than their fair market value and suffered substantial damages. When the true factual situation was disclosed, the market prices significantly declined in consequence. Plaintiffs relied upon the integrity of the market in making their purchases of Documation's securities. Plaintiffs informed the court below that they were able to plead direct reliance on documents referred to in the complaint, but argued successfully that reliance on the integrity of a developed market for securities fully met their burden in pleading.

Peat, Marwick, Mitchell & Co. ("PMM"), Documation's independent Certified Public Accountants in the relevant period, audited and reported on certain Documation financial reports contained in documents publicly disseminated. PMM's reports of March 30, 1978 and March 16, 1979, stating that its examination was in accordance with generally accepted auditing standards and that Documation's financial position was fairly set forth in conformity with generally accepted accounting principles applied on a con-

sistent basis, were false. PMM knew or recklessly disregarded the material adverse facts concerning Documation's revenues, earnings, assets, retained earnings and net worth. While alleging that PMM knew that its reports on Documation would influence the public market price of Documation securities and alleging reliance on the integrity of the market in making plaintiffs' purchase, the Complaint also specifically alleges as against PMM that plaintiffs "relied upon the absence of material adverse information about Documation" (¶57) and "did not know and had no reason to believe, that the . . . financial statements and PMM's reports thereon contained untrue statements of material facts or material omissions" (¶55).

Proceedings Below

Petitioners-defendants moved in the district court to dismiss the Complaint for failure to allege fraud with the required particularity and for failure to state a claim upon which relief could be granted (Rules 9(b) and 12(b)(6) of the Federal Rules of Civil Procedure). Following denial of the motions, defendants filed answers and plaintiffs moved for class certification. PMM also moved for certification, pursuant to 28 U.S.C. §1292(b), of the district court's ruling that the allegations of reliance on the integrity of the market were sufficient and that plaintiffs need not plead direct reliance. The district court granted §1292(b) certification and simultaneously stayed all further proceedings. No discovery or depositions of plaintiffs have been taken nor have plaintiffs been able to obtain any discovery of defendants. There is no factual record beyond the pleadings.

A unanimous Eleventh Circuit panel found that the prior opinion of the Fifth Circuit in *Shores* v. *Sklar*, 647 F.2d 462

(5th Cir. 1981) (*en banc*), *cert. denied*, 459 U.S. 1102 (1983) required the court to "recognize the fraud on the market theory as a basis for recovery where the defendant's deception inflates open market stock prices. To hold otherwise would result in this circuit adopting the theory in a setting where its applicability has been questioned, and rejecting its use where it best advances the goals of the federal securities laws." 734 F.2d at 745.

The panel also found, "independently" of binding Fifth Circuit precedent,[2] that the fraud on the market theory should be recognized. The court, quoting from *Blackie* v. *Barrack*, 524 F.2d 891, 906 (9th Cir. 1975), stated:

> We agree with the Ninth Circuit that:
>
> causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance. Materiality circumstantially establishes the reliance of some market traders and hence the inflation in the stock price—when the purchase is made the causational chain between defendant's conduct and plaintiff's loss is sufficiently established to make out a prima facie case.

734 F.2d at 747. The court of appeals recognized that the fraud on the market theory does not eliminate the element of causation-in-fact. The theory provides that, where plaintiff alleges materiality and the purchase of securities in the open market, reliance may be presumed, "subject to the defendant proving that the misrepresentations were not material or that the plaintiff's decision to purchase

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[2] The Eleventh Circuit, in the *en banc* decision *Bonner* v. *City of Prichard*, 661 F.2d 1206, 1209 (11th Cir. 1981), adopted as precedent decisions of the Fifth Circuit rendered prior to October 1, 1981.

was or would have been unaffected if he had known the true facts." 734 F.2d at 748.

Thereafter, a suggestion of rehearing *en banc* was denied, with no member of the panel or circuit judge in active service having requested that the court be polled.

REASONS FOR DENYING THE WRIT

The Eleventh Circuit, following Fifth Circuit precedent, has done nothing more than affirm the application of the "fraud on the market" theory to its most appropriate instance—the traditional developed open market fraud case involving inflation of the market price of securities. In this context, the adequacy of pleading reliance on the integrity of the market has gained an overwhelming consensus in the federal courts. There is no dispute among the circuits, nor in the district courts, nor among the commentators. Petitioners do not contend otherwise. The Eleventh Circuit's opinion, affirming a well-established application of Rule 10b-5(1) and (3) to its paradigm case, does not raise any issue which warrants the attention of this Court.

The absence of any factual record, a consequence of the interlocutory nature of the appeal from denial of the motions to dismiss the Complaint, further militates against review.

There Is No Conflict With the Decisions of Other Circuits; There Is No Issue Which Needs to Be Settled by This Court

An overwhelming consensus has been reached among the federal judiciary and the commentators as to the question presented here, *i.e.* in what form causation/reliance need be pled in a securities fraud action complaint sufficient to withstand a motion to dismiss. When securities are publicly traded in a developed open market, the price of the securities reflects publicly available material information. It is therefore sufficient to plead reliance on the integrity of the market. This proposition has been termed "fraud on the market," *In re Memorex Security Cases*, 61 F.R.D. 88, 99 (N.D. Cal. 1973).

The sufficiency of pleading reliance on the integrity of the market in the stock exchange context has been explicitly or implicitly accepted by every circuit court of appeals to have discussed the question. *Blackie* v. *Barrack*, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976); *T.J. Raney & Sons, Inc.* v. *Fort Cobb, Oklahoma Irrigation Fuel Authority*, 717 F.2d 1330 (10th Cir. 1983), *cert. denied*, —— U.S. ——, 104 S.Ct. 1285, 79 L.Ed.2d 687 (1984); *Shores* v. *Sklar*, 647 F.2d 462 (5th Cir. 1981) (*en banc*), *cert. denied*, 459 U.S. 1102 (1983); *Ross* v. *A.H. Robins*, 607 F.2d 545, 553 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); *Wachovia Bank & Trust* v. *Nat. Student Marketing*, 650 F.2d 342, 357 (D.C. Cir. 1980), *cert. denied*, 452 U.S. 954 (1981) ("Section 10(b) presumes reliance if . . . the misstatement affects the price of the stock").

In circuits that have not considered the adequacy of pleading "fraud on the market," district courts have accepted such pleading as sufficient. See (Third Circuit) *In re Ramada Inns Securities Litigation*, 550 F. Supp. 1127

(D. Del. 1982) and *Wolgin* v. *Magic Marker Corp.*, 82 F.R.D. 168 (E.D.Pa. 1979); (Fourth Circuit) *Frankel* v. *Wyllie & Thornhill*, 537 F. Supp. 730 (W.D. Va. 1982); (Seventh Circuit) *Grossman* v. *Waste Management*, 589 F. Supp. 395 (N.D. Ill. 1984) and *Mottoros* v. *Abrams*, 524 F. Supp. 254 (N.D. Ill. 1981); (Eighth Circuit) *In re McDonnell Douglas Corp. Securities Litigation*, 587 F. Supp. 625 (E.D. Mo. 1983) and *Dekro* v. *Stein*, 540 F. Supp. 406 (W.D. Mo. 1982). See generally the thorough discussion by Judge Higginbotham in *In re LTV Securities Litigation*, 88 F.R.D. 134 (N.D. Tex. 1980).

The fraud on the market theory advanced by the Eleventh Circuit in this case, giving plaintiffs a rebuttable presumption of reliance on the integrity of prices in the context of a developed market, has also been endorsed by the commentators.[3] For instance:

> A fraud on the market theory dispensing with a requirement that investors must actually read the disclosure documents is sound in the case of widely-traded securities. Affording plaintiff a presumption of reliance in the case of widely-traded securities follows logically from the efficient-market theory, and it is appropriate to transfer to the defendant the burden of disproving reliance.

Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Trans-*

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[3] Every commentator cited by petitioners supports the proposition here endorsed by the Eleventh Circuit. See also, Fischel, *Use of Modern Finance Theory In Securities Fraud Cases Involving Actively Traded Securities*, 38 Bus. Law. 1 (1982). The root notion that when a misstatement inflates values on the market and a buyer relies thereon, the buyer should be able to recover damages, was expressed by Professor Berle as early as 1931. Berle, *Liability for Stock Market Manipulation*, 31 Colum.L.Rev. 264, 269 (1931).

actions, 62 N.C.L. Rev. 435, 473 (1984). Similarly, Note, *The Fraud-on-The-Market Theory,* 95 Harv.L.Rev. 1143 (1982).

Significantly, two circuits that have not yet addressed "fraud on the market" have recently refused to accept 28 U.S.C. §1292(b) interlocutory appeals certified by district courts endorsing the theory. *Waste Management, Inc.* v. *Grossman,* Misc. No. 84-8048 (7th Cir. Oct. 4, 1984); *In re McDonnell Douglas Corp. Securities Litigation,* Misc. No. 84-8010 (8th Cir. Jan. 26, 1984). Evidently, neither circuit court of appeals found the question of law presented by petitioners to pose "substantial ground for difference of opinion" where resolution on appeal "may materially advance the ultimate termination of the litigation." 28 U.S.C. §1292(b).

It is thus clear that the opinion of the Eleventh Circuit falls within the sensible consensus view of the pleading requirements on reliance taken by the federal judiciary and the commentators; no issue requiring settlement by this Court is presented.[4] Indeed, no authority rejecting the fraud on the market theory as applied to developed markets has been cited by petitioners.

Petitioner in No. 84-646 (Peat, Marwick, Mitchell) views as the primary danger requiring review the supposed overbroad use of the efficient capital market hypothesis by "some" federal courts. Yet even the authority relied on by petitioner argues that the efficient capital market hypo-

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[4] Petitioners rely on this Court's grant of certiorari in *Price Waterhouse* v. *Panzirer,* 458 U.S. 1105, *vacated as moot,* 459 U.S. 1027 (1982). However, the question presented and the procedural posture of that case were completely different. *Panzirer* v. *Wolf,* 663 F.2d 365 (2d Cir. 1981). Unlike the instant case, in *Panzirer,* there was a factual record regarding the circumstances of plaintiff's purchase, permitting review of the question of whether the chain of causation was too remote. This factual record was specifically referred to in the question presented.

thesis is acceptable where there is an active developed secondary market and the information at issue is publicly disclosed (therefore reducing costs of acquiring information to a minimum). See, Gilson and Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549, 609-610 (1984). This is, of course, the case here.

Causation is not eliminated as defendants contend. As then District Judge Higginbotham stated in his oft cited opinion in *In re LTV Securities Litigation, supra,* 88 F.R.D. at 144:

> The fraud on the market theory does not eliminate the element of reliance but places it where in open market transactions it realistically belongs—connecting the purchaser to the market, not the specific misstatement.

The Eleventh Circuit opinion recognizes that, while reliance/causation may be presumed once materiality and market purchases are established under the fraud on the market theory, the presumption is "subject to the defendant proving that the misrepresentations were not material or that the plaintiff's decision to purchase was or would have been unaffected if he had known the true facts." 734 F.2d at 748. If the defendant can show no causation-in-fact, it would defeat recovery; the requirement of causation is preserved.

Petitioners' additional argument that the implied private right of action under §10(b) "nullifies" the remedy of §18, and that the legislative history of §18 "conflicts" with the pleading requirements as to reliance in §10(b) actions, opinion is simply wrong. Because Section 10(b) (unlike Section 18) imposes on a plaintiff the burden of proving *scienter*, the circuit courts have held these remedies to be cumulative. *Wachovia Bank & Trust* v. *Nat. Student Marketing, supra,*

650 F.2d at 354-359 and *Ross* v. *A.H. Robins, supra,* 607 F.2d at 551-556, cited in *Herman & MacLean* v. *Huddleston,* 459 U.S. 375, 103 S.Ct. 683, 689 n.21 (1983), for the proposition that "lower courts have continued to recognize that an implied cause of action under Section 10(b) can be brought regardless of whether express remedies are available."

The further argument that the "fundamental tort law of reliance", as traditionally defined in the action for deceit, has been "disregarded" ignores the holding of the court of appeals that the presumption of reliance on the integrity of the market can be rebutted. It also contravenes the teaching of this Court that "the anti-fraud provisions of the securities laws are not coextensive with common law doctrines of fraud. Indeed, an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common law protections by establishing higher standards of conduct in the securities industry [footnote omitted]." *Herman & MacLean* v. *Huddleston, supra,* 103 S.Ct. at 691.

The final argument of petitioners is that somehow *Lipton* v. *Documation* creates a scheme of "investors' insurance." The substance of the argument is that because it may prove difficult for defendants to rebut the presumption of reliance on the integrity of the market, the causation requirement has been eliminated, and that the accounting profession will be liable for honest errors in judgment. Moreover, PMM contends that auditors who give professional certifications of financial statements for public dissemination are entitled to special consideration under the securities laws.

First, it should be emphasized that *audited* financial statement are normally heavily relied upon by public investors. Indeed, any significant change of an accountant's

audit opinion of an issuer's financial condition will directly affect the market prices of the issuer's securities. Thus, it can hardly be said that a public auditor, or audited financial statements, play a peripheral or tangential role in the integrity of the marketplace.

Second, the presumption of reliance in the developed market context presented here is quite appropriate as virtually every court has recognized. The causal connection is clear and direct. If a defendant can demonstrate the lack of materiality of the misrepresentation, or can prove that the security was purchased for reasons irrelevant to reliance on the integrity of the market, the presumption is rebutted. But this depends on the facts brought forward by the defendant. Petitioners apparently seek review of this "rebuttal" issue by reference to facts not in the record. See "Questions Presented," *supra*.

Finally, the purported threat of unlimited liability for investor losses in class actions is simply not present. The "fraud on the market" theory does not do away with the heavy burdens which a plaintiff still must overcome, *inter alia* proving *scienter*, materiality and damages. The question in this case is not liability for honest errors in judgment. Rather, the question is whether a plaintiff may recover when defendants, with wrongful intent, commit fraud upon open market investors.

The Decision Below Is Interlocutory; This Court Should Not Rule on the Fraud on the Market Theory and the Causation Element of Section 10(b) and Rule 10b-5 in the Absence of a Factual Record

The procedural posture of this case militates against granting review. Nearly four years have passed since the Complaint at issue was filed; no discovery has been had. The court below held sufficient the general allegations that plaintiffs relied on the integrity of the market in purchasing their Documation stock, which allegations give rise to a presumption that there is a sufficient causal connection to sustain a *prima facie* case.

Petitioners claim that plaintiffs have conceded the nonexistence of any causal connection by admitting their unawareness of the documents in question or even "the auditors existence". There are no such facts in the record. Thus, they ask this Court to issue an advisory opinion on a hypothetical fact situation.

The facts concerning plaintiffs' reliance on the integrity of the market have not yet been adduced. Moreover, it is impossible to determine whether the legal questions which Petitioners seek to litigate will be dispositive.[5] If plaintiffs prevail after trial, this Court would have the benefit of a full record to assist it in analyzing the issues. This Court has long recognized the disadvantages inherent in review on interlocutory appeal. See, *United States* v. *Freuhauf*, 365 U.S. 146, 157-158 (1961); *Hamilton-Brown Shoe Co.* v. *Wolf Brothers*, 240 U.S. 251, 257-258 (1916); *American Construction Co.* v. *Jacksonville Ry.*, 148 U.S. 372, 384 (1893).

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[5] For example, plaintiffs have alleged an alternate theory of recovery under *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972). See ¶57 of the Complaint.

CONCLUSION

The petitions for a writ of certiorari should be denied.

Respectfully submitted,

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